MICHAEL J. MURPHY
State Treasurer

Third Quarter 2005

The QUARTERLY

Local Government Investment Pool

In search of the neutral zone in fed funds

The Federal Open Market Committee (FOMC) continued raising its target for the federal funds rate by 25 basis points to 3.75 percent. The Fed appeared to be taking a path of "measured" rate hikes until tragedy struck the Gulf region and the market expected monetary policy to be quite difficult to forecast in terms of the so-called "neutral zone."

This "neutral zone" is the area where the fed funds rate does not appear too accommodative to kindle inflation and at the same time does not constrict long-term economic growth.

Investors started questioning the wisdom of continued rate hikes amidst the devastation and the attendant economic toll that will cost the US billions of dollars in reconstruction. Speculations abound that the Fed could pause in order to reassess the country's overall economic health with the devastation in mind and also the grief of higher energy prices for US consumers.

The bond markets reflected the current worries of a slowdown and even a recession next year while it also cautioned investors of the need to be vigilant against inflation. Investors are at the crossroads of two valid arguments that could create tremendous opportunities in an environment of a flat or nearly inverting yield curve.

The Fed made mention that "output appeared poised to continue growing at a good pace before the tragic toll of Hurricane Katrina." The devastation in the Gulf region after Katrina, exacerbated by Hurricane Rita, had investors worried about economic dislocation and higher energy prices. Energy prices had consumers very worried about supply and the cost-push inflationary effect. Transportation, shipping, services and basic goods would have an energy component added to their costs. These worries were pacified by the Fed during its September meeting by releasing a statement that "… unfortunate developments have increased uncertainty about the near-term economic performance (but) they do not pose a more persistent threat."

The Fed has taken a more optimistic view: that the underlying growth of the US economy would support economic activity despite inflation pressures brought about by higher oil prices. On examination of the Fed's released statements, market-watchers believe the Fed has also given investors a glimpse of its bias in fighting inflation expectations and its willingness to accept slower growth. Economists in a Bloomberg survey predicted that the Fed would continue raising rates 4.25 to 5 percent through the end of 2006. This view illustrates the risk of energy prices having a tremendous impact, spilling over into longer-term inflation expectations.

Hurricanes' cost

Early estimates of Hurricanes Katrina and Rita are likely to shave about 0.5 percent from the gross domestic product in the second half of 2005. Most of the slowdown will occur during the third quarter of CY 2005 before rebuilding efforts take effect during the fourth quarter of CY 2005. The multiplier effect of higher economic activity will be felt when rebuilding stimulates the economy by the latter part of 2006, according to the government estimates.

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Market summary

from page 1

Around $62 billion dollars of federal spending has been authorized by the Congress and a possible similar amount of insurance money. These funds would ensure that the affected states could get back on their feet as soon as possible. Louisiana, which bore the brunt of Katrina, has started reconstruction. The total cost of rebuilding is estimated to be around $200 billion, added to the $350 billion federal budget deficit. The U.S. government has said that most of the added cost will be financed by selling U.S. bonds. With the current savings rate now below zero, the U.S. is expecting foreign countries to finance the deficit, as has been the case for some time now.

Recent ISM figures suggest that, contrary to expectations, manufacturers experienced significantly higher numbers in both new orders and new export orders. Although it is questionable to draw conclusions, near-term weakness resulting from the hurricanes proved very temporary. Manufacturers instead saw the hurricanes as an opportunity to ramp up production due to anticipated supply bottlenecks. The forward-looking sub-components of the ISM numbers saw a 14-month high in new orders attesting to the robustness of U.S. economic activities. Investors are awaiting further validation of economic growth.

The housing market and the U.S. economy

There have been numerous occasions that Chairman Greenspan discussed inflated housing prices and the current practice of home equity extraction. There is no doubt the buoyant housing market has fueled both construction and consumer spending. With the national savings rate below zero percent, home equity became a cash cow that maintained the economy's surprising growth. With the rise in interest rates, the only spigot of cash for consumers might dry up which could result in slower-than-expected spending. Consumers, at this juncture, are battered by higher interest rates, higher energy prices and higher inflation that could tip the economy back into a slowdown or a recession.

This has created uncertainty in the bond market. Investors are still evaluating if the Fed will focus its attention on quelling inflation fears or shift its concern to factors that might cause a slowdown in the country's economic growth. At this juncture, the Fed has issued statements that say inflation is more of a concern than slowing economic growth. Recent job figures attest to the fact that the hurricanes created only a minor blip in growth but boosted inflation numbers due to shortage of raw materials, energy prices, and supply bottlenecks. The only offsetting factor that might curb inflation is the decline in consumer confidence. The verdict is still up in the air about which factor would affect the Fed's future decision on the level of neutrality in Fed funds rate to support its twin objective of price stability and sustainable economic growth.

A flat or inverting yield curve: Take your pick

The deafening warnings by Fed governors about their inflation concern created more of the same bond market action seen during the last quarter, namely a flatter and almost inverting yield curve.

The two-year note saw yields rise from a low of 4.03 percent to 4.203 percent after two hurricanes hit the Gulf Coast. The interest rate on the longer-term 10-year bonds had yields between 4.00-4.384 percent. There was a definite trading band that most players respected between the short and long-term area, depending on their steepening or flattening positions. Unwinding steepeners were employed at the higher end of the range and flatteners were set at times when investors felt the need to reset their positions. Trading was data-driven as investors still have no clue if the Fed will move more aggressively in future meetings.

The Fed's recent statement briefly touched on the need to remove the word "accommodative" in describing monetary policy as the fed funds rate approaches what most consider neutral rates. Inflation numbers will

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360-902-9020

Pam Johnson
LOCAL specialist
360-902-9021

Treasurer to issue RFP for statewide custody provider

The Office of the State Treasurer is again seeking applicants to provide statewide custody services.

As with the awarding of the first statewide custody contract to the Bank of New York (BONY), local entities and the LGIP Advisory Committee will be extensively involved in overseeing the process.

BONY's appointment as the statewide custody provider ends March 31, 2006. The request for proposal (RFP) for the next provider is expected to be released Nov. 17.

A little history:

In January 1999, the Office of the State Treasurer, with input from local governments, introduced legislation designed to enable local governments and institutions of higher education to contract with a statewide custody provider chosen by the State Treasurer.

The legislation, now codified as RCW 43.08.280, was passed unanimously by both the House and Senate and signed into law by the governor.

The initial RFP process culminated in the January 2000 selection of BONY as the first statewide provider of custody services. BONY agreed to a uniform fee schedule under terms of a model contract which, upon execution, was solely between the local entity and BONY.

The appointment of BONY was effective from April 1, 2000, through March 31, 2004, with a potential two-year extension. Based on a survey of participants, which showed unanimous satisfaction with BONY's services, the two-year extension was implemented.

As of September 2005 there were 20 local entities using the statewide custody program to safeguard portfolios with a combined market value of $1.026 billion.

The appointment of the statewide custody provider is scheduled to be completed by the end of January 2006, with an effective date of April 1, 2006.

Market summary
continued

be the most-watched economic indicators going forward since the Fed showed its concern about rising prices. The Fed will keep hiking rates if inflation is viewed as more of a threat.

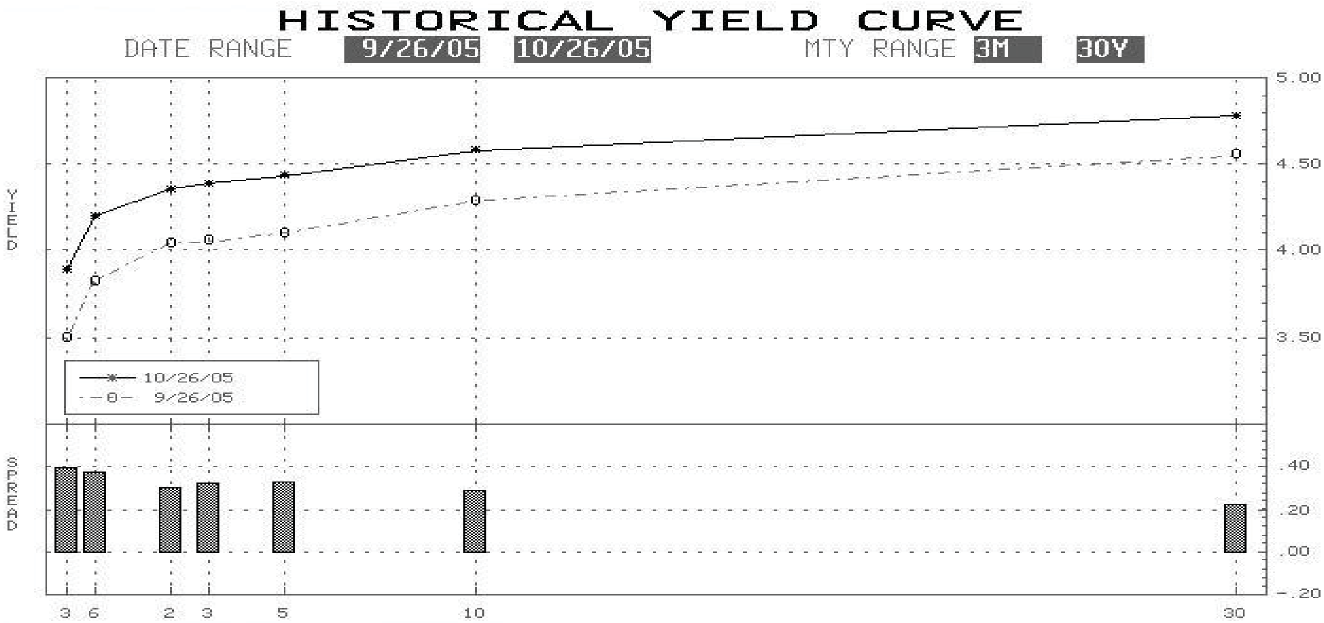
With PPI and CPI showing some significant gains due in part to energy prices and the hurricanes, the market is discounting more fed rate hikes in the near future.

The LGIP

In what is continuing to sound like a broken record, the fed funds rate was raised by 25 basis points at both the August and September Fed meetings and again on Nov. 1, bringing the rate to 4 percent. In anticipation of rising rates, the average life of the LGIP portfolio has been kept short, at around 30 days, in order to be able to reprice to the rising rate as quickly as possible.

The net LGIP yield increased from 3.21 percent to 3.40 percent and then to 3.58 percent during July, August and September.

LGIP participants should expect LGIP yields to continue to rise as long as the Fed continues to raise the fed funds rate.



From the LGIP Administrator’s Desk

By Robbi Stedman

Office of the State Treasurer staff celebrated the completion of its Treasury Management System with a party Oct. 20. TM$ usage continues to increase, with approximately 73 percent of daily transactions completed through TM$.

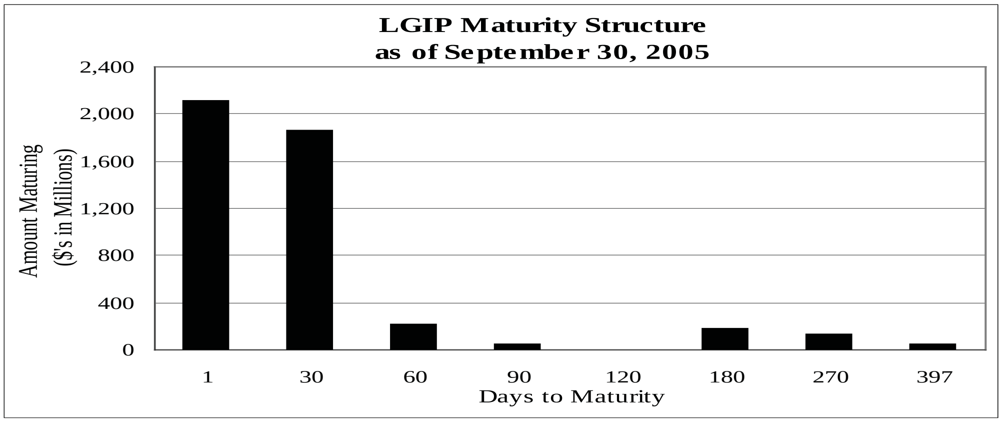
One of the goals in our business plan is education. One way we hope to accomplish that is by coordinating speakers at conferences. This past September at the WFOA conference we presented five different investment classes. For the most part we were happy with how they went and attendance was higher than ever. We will offer the same number of classes for next year’s WFOA conference in Tacoma. We are starting to plan now for next year, and we’re open to suggestions for what you would like to hear in our classes.

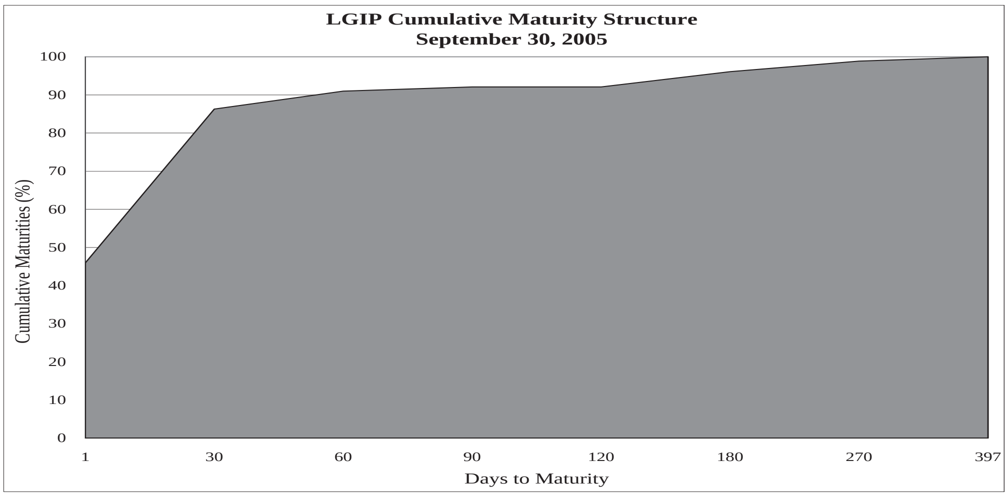
Just a reminder for those of you who are newer to the LGIP: You need to let us know if you are making a deposit. There seems to be some who believe you only have to let us know if you are withdrawing money from the pool. However, to get credit for the deposit the day you actually send it, you have to let us know just as you would a withdrawal. Also, make sure that you call 1-800-331-3284 rather than my direct number for transactions.

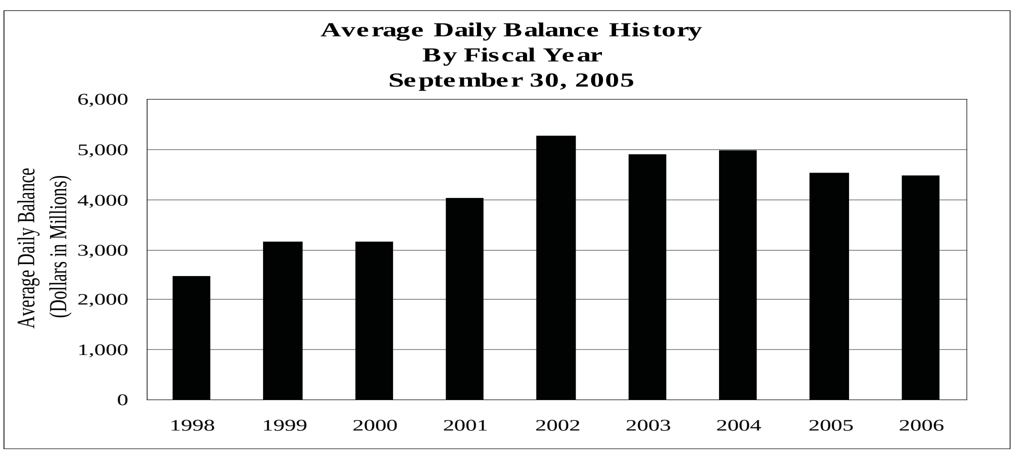
LGIP Holiday Schedule for 2005-2006

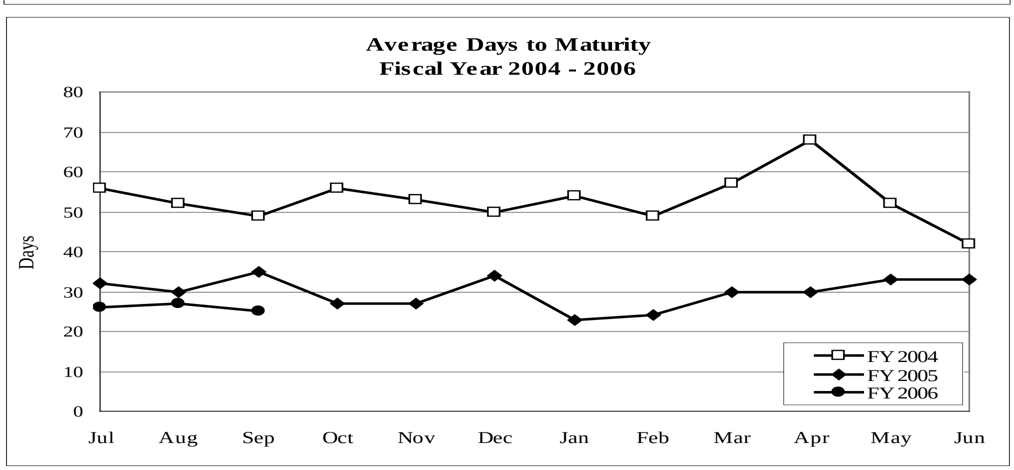
The Local Government Investment Pool will be closed on the following days:

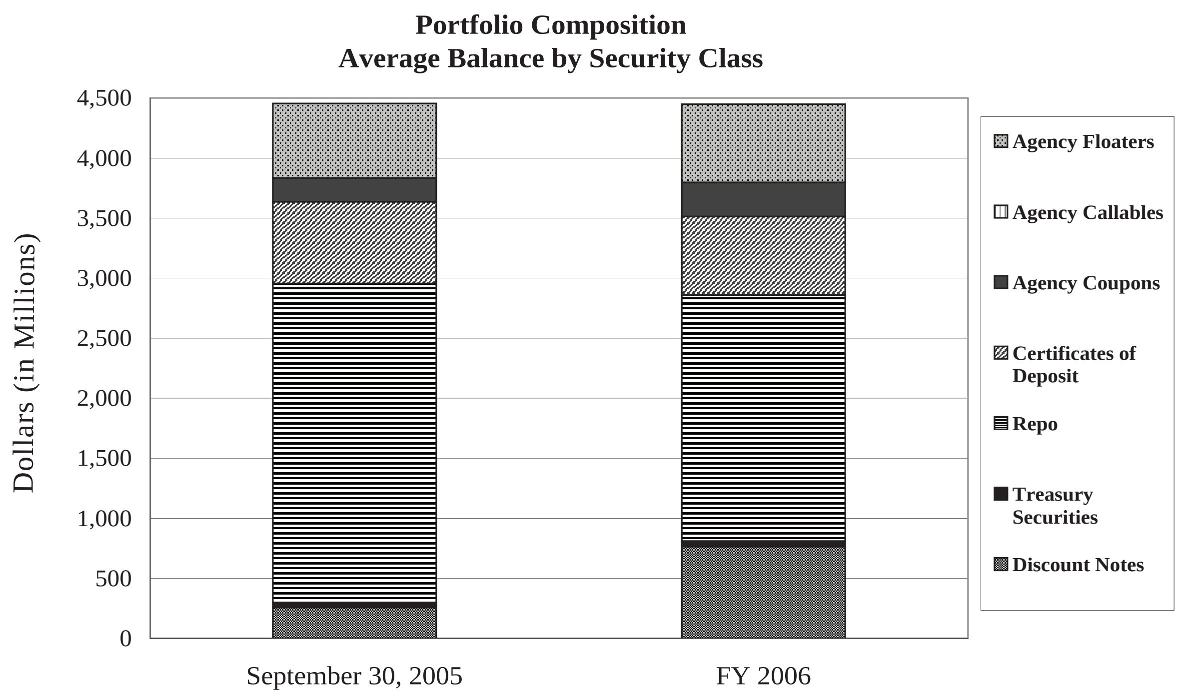
Monday	September 5	Labor Day
Monday	October 10	Columbus Day
Friday	November 11	Veteran’s Day
Thurs/Fri	November 24-25	Thanksgiving Holiday
Monday	December 26	Christmas
Monday	January 2	New Year’s Day
Monday	January 16	Martin Luther King, Jr. Day
Monday	February 20	President’s Day
Monday	May 29	Memorial Day
Tuesday	July 4	Independence Day

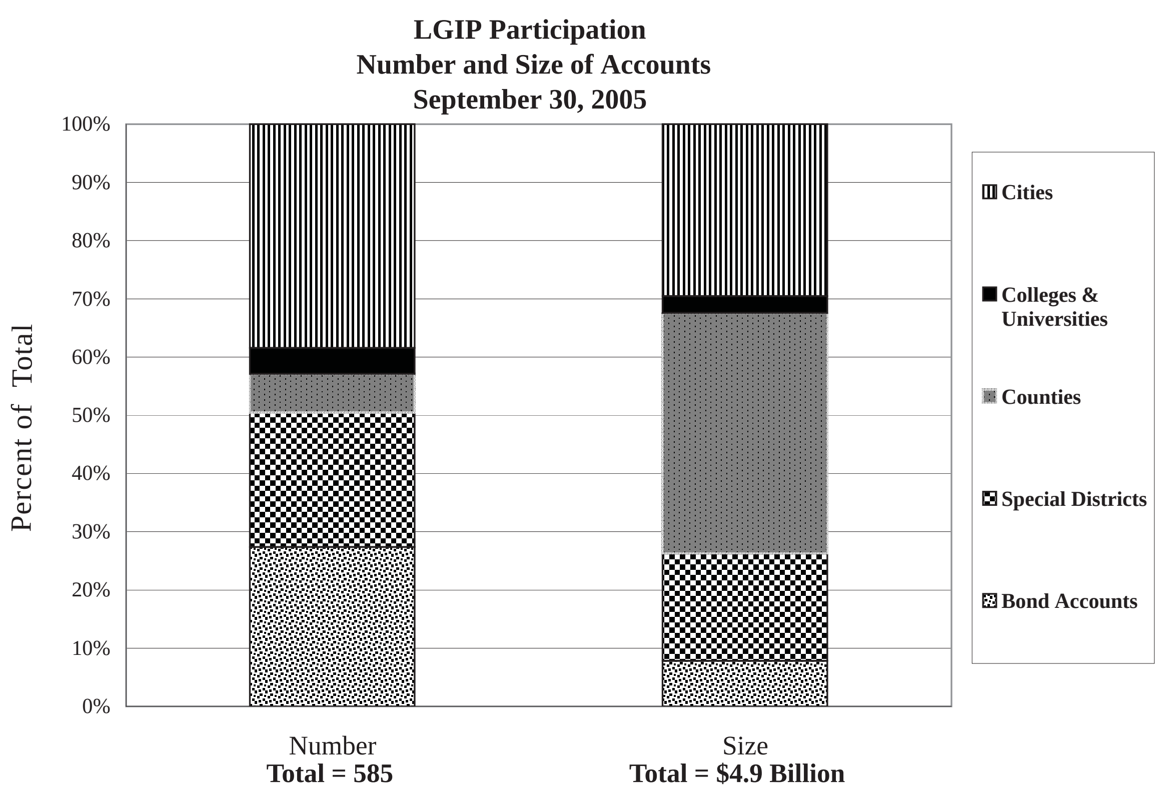

LGIP Maturity Structure
as of September 30, 2005
Amount Maturing ($'s in Millions)
2,400
2,000
1,600
1,200
800
400
0
1
30
60
90
120
180
270
397
Days to Maturity


LGIP Cumulative Maturity Structure
September 30, 2005
Cumulative Maturities (%)
100
90
80
70
60
50
40
30
20
10
0
1
30
60
90
120
180
270
397
Days to Maturity


Average Daily Balance History
By Fiscal Year
September 30, 2005
Average Daily Balance (Dollars in Millions)
6,000
5,000
4,000
3,000
2,000
1,000
0
1998
1999
2000
2001
2002
2003
2004
2005
2006


Average Days to Maturity
Fiscal Year 2004 - 2006
Days
80
70
60
50
40
30
20
10
0
Jul
Aug
Sep
Oct
Nov
Dec
Jan
Feb
Mar
Apr
May
Jun
FY 2004
FY 2005
FY 2006


Portfolio Composition
Average Balance by Security Class
4,500
4,000
3,500
3,000
2,500
2,000
1,500
1,000
500
0
Dollars (in Millions)
September 30, 2005
FY 2006
Agency Floaters
Agency Callables
Agency Coupons
Certificates of Deposit
Repo
Treasury Securities
Discount Notes


LGIP Participation
Number and Size of Accounts
September 30, 2005
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Percent of Total
Number
Total = 585
Size
Total = $4.9 Billion
Cities
Colleges & Universities
Counties
Special Districts
Bond Accounts

LGIP Advisory Committee: October 21 meeting minutes

The LGIP Advisory Committee met Oct. 21, 2005, at noon in the House Rules Room, Legislative Building, Olympia, Washington. The following members were present: Carrie Lewellen, Shelley Pearson, Morgan Jacobson, Lisa Frazier, Dani Burton, Mark Wyman and Lynn Hills. Treasurer's Office staff included State Treasurer, Michael J. Murphy, Assistant Treasurer Michael Colleran, Doug Extine, Joshua Freese, and Robbi Stedman. The following members were absent: Chuck Greenough, Dan Underwood, Barbara Stephenson, Tracy Shawa, and Stan Finkelstein.

Treasurer Murphy welcomed three members of the Statewide Custody Program Search Evaluation Team. They included Katie Jungquist of Skagit County, Karen Thomas of Whatcom County, and Kelley Wood from the City of Redmond. The evaluation team met that morning just prior to the LGIP Advisory Committee Meeting.

Treasurer Murphy announced that Mark Wyman was leaving the committee after taking a different job. Mark represented Washington Public Utility District Association and his new job is as an investment officer with Thurston County. Treasurer Murphy presented Mark with a plaque of appreciation for his eight-year tenure on the committee.

Treasurer Murphy also introduced Joshua Freese, the new Portfolio Administrator for the Investment Section. Josh is a graduate of the University of Washington and he will be an excellent addition to the staff.

Doug Extine gave an update on the performance of the LGIP. The net rates for the Pool for July, August, and September were 3.21 percent, 3.4 percent and 3.58 percent, respectively. The Fed has tightened by 25 basis points (bp) every FOMC meeting since June 30, 2004. It is widely anticipated to continue for at least the November 1 and December 13 meetings, bringing the fed funds rate to 4.25 percent by the end of 2005. He anticipated that the LGIP gross earnings rate for October will be about 3.77 percent. Doug also distributed a handout that compared the Pool rates with the Targeted Fed Funds Rate since July of 2004, to show how close the Pool has stayed to the Fed.

Doug spoke about the strategy for managing the LGIP portfolio. Currently, the portfolio has an average life of 24 days. The strategy is to keep it short in anticipation of continued fed fund increases. Doug also spoke about how the portfolio has shifted to more term repurchase agreements due to the expensive nature of agency discount notes. Discussion followed.

Robbi distributed a handout to committee members describing the month-end balance activity from June 2003 to the present and also the daily balance activity for the first part of Fiscal Year (FY) 2006. The month-end balances for July, August, and September have remained very even compared with previous fiscal years.

Doug reviewed the FY 2005 budget and the estimate for FY 2006. The estimate for 2006 of fees and overdraft charges is $1.403 million, which is based on an average daily balance of $4 billion. stimated expenses are $581,000 with an anticipated rebate of $822,000. Another handout was distributed showing the historical expenses of the LGIP from FY 2000-2006. It showed the average daily balance, expenses, and the net fee, in basis points. These net rates ranged from 0.9 bp to 2.0 bp. Comparable outside fees would be around 40 basis points.

Robbi's TM$ update showed usage has continued to grow. Approximately 73 percent of daily transactions are done online by the participants. Robbi also spoke about the potential transition from the Bank of America's BAMTRAC system to the internet-based BA Direct. The BAMTRAC account transfer system used by some Bank of America customers to transfer funds into the LGIP was eliminated as of August 2005. Robbi discussed the 2005 Washington Finance Officers Association 2005 conference and the OST-coordinated investment education classes. Feedback was solicited as to possible improvements as well as potential topics for the 2006 conference. Discussion followed.

Doug discussed the upcoming search for the next statewide custody provider. He discussed the Statewide Custody process and its origins and introduced the members of the Evaluation Team: Carrie Lewellen, Shelley Pearson, Karen Thomas, Kelley Wood, and Katie Jungquist. Doug distributed the Statewide Custody Provider RFP time line, which begins with the RFP release on Nov. 17 and culminates with an evaluation team recommendation to the Advisory Committee on Jan. 27, 2006.

The evaluation team will be visiting New York Nov. 6-10 to pay a due diligence trip to the Bank of New York, which serves as the custody provider and securities lending agent for OST. Discussion followed.

Lynn Hills from the Port of Bremerton will be retiring in November, so will be replaced on the committee by Mary Nelson of the Port of Grays Harbor. Lynn has served as a member of the Advisory Committee since 1995. State Treasurer Murphy thanked Lynn for her 10 years of service on the committee.

The next meeting will be Jan. 27, 2005.

The meeting was adjourned at 2 p.m.

Washington State Local Government Investment Pool
Position and Compliance Report
as of 09/30/2005
(Settlement Date Basis)

(In Thousands)

LGIP Portfolio Holdings

	Amortized Cost	Percentage of Portfolio
Agency Bullets	$ 144,491	3.14%
Agency Discount Notes	152,272	3.31%
Agency Floating Rate Notes	621,098	13.49%
Certificate of Deposit	132,250	2.87%
Interest Bearing Bank Deposits	548,405	11.92%
Repurchase Agreements	2,979,078	64.73%
U.S. Treasury Bills	0	0.00%
U.S. Treasury Coupons	24,988	0.54%
	$ 4,602,582	100.00%

Securities Lending Holdings

Repurchase Agreements	$ 27,641
	$ 27,641
Total Investments & Certificates of Deposit	$ 4,630,223

Policy Limitations

*The policy limitations include investment of cash collateral by a securities lending agent calculated as percentages of the portfolio holdings Total Excluding Securities Lending.**

Size Limitations

	Holdings	Percentage of Portfolio	Policy Limitations Percentage
Floating Rate and Variable Rate Notes	$ 621,098	13.49%	30%
Variable Rate Notes > 397 Days	0	0.00	10%
Other Structured Notes	0	0.00	10%
Term Repo > 30 Days	0	0.00	30%
Certificate of Deposit	132,250	2.87	10%
Bankers' Acceptances	0	0.00	20%
Commercial Paper	0	0.00	25%
Reverse Repo	0	0.00	30%
Security Lending + Reverse Repo	26,956	0.59	30%

Maturity Limitations

	Currently	Policy Limitations
Weighted Average Maturity	25 day(s)	90 day(s)
Maximum Maturity		
Bullet Maturities	354day(s)	397 day(s)
Floating Rate and Variable Rate Notes	504day(s)	762 day(s)
Repos	28day(s)	180 day(s)
Reverse Repos	0 day(s)	90 day(s)

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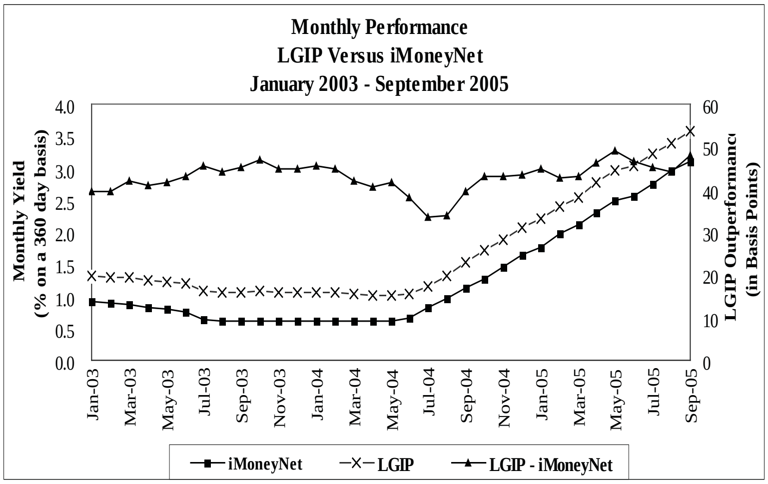
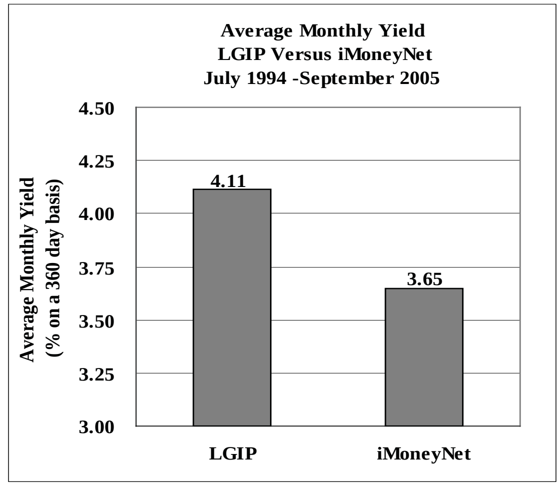
LGIP Performance Comparison

iMoneyNet, Inc. [1]
versus
Local Government Investment Pool





The chart on the left shows a monthly comparison from January 2003 through September 2005 and how the LGIP has consistently outperformed the benchmark.

The chart on the right shows an average monthly yield comparison from July 1994 to September 2005. The LGIP net rate of return has outperformed its benchmark during that time period by an average of 46.4 basis points. This translates into the LGIP earning $176.14 million over what the average comparable private money fund would have generated.

[1] Average Net Rate of Return of Government Only/Institutional Only Money Market Funds, Money Market Insight, iMoneyNet, Inc., West borough, MA. This benchmark is comprised of privately managed money market funds similar in composition and investment guidelines to the LGIP.

Position and Compliance Report as of 9/30/05
from page 8

Repo Limits Per Dealer

	September 30, 2005	Total Repo Percentage (20% limit)	Term Repo Percentage (10% limit)	Projected Redemptions 10/03/2005	Projected Position 10/03/2005
Banc America Securities	$ 800,000	17.38%	0.00%	$ 800,000	$ 0
Bear Stearns & Co.	800,000	17.38%	8.69%	400,000	400,000
Greenwich Capital	300,000	6.52%	6.52%	0	300,000
Lehman Brothers Inc.	479,078	10.41%	0.00%	479,078	0
Merrill Lynch	200,000	4.35%	0.00%	200,000	0
Morgan Stanley Dean Witt	427,641	9.29%	8.69%	27,641	400,000
Total	$ 3,006,719			$1,906,719	$1,100,000

Local Government Investment Pool

STATEMENT OF NET ASSETS

September 30, 2005

(In Thousands)

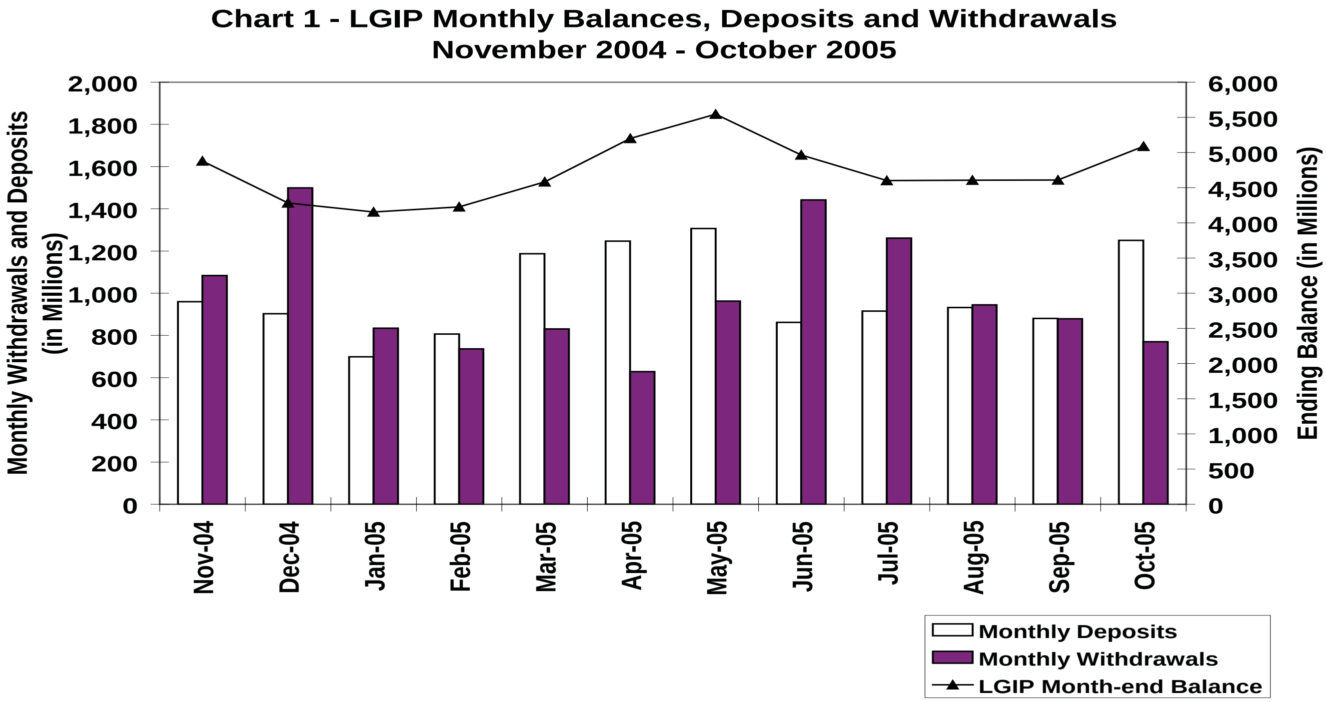
Assets	
Investments, at Amortized Cost:	
Repurchase Agreements	$ 2,979,078
U.S. Agency Securities	917,861
U.S. Treasury Securities	24,988
Total Excluding Securities Lending	$ 3,921,927
Securities Lending Investments, at amortized cost:	
Repurchase Agreements	27,641
Total Investments (Settlement Date Basis)	$ 3,949,568
Due from Brokers - Securities Purchased But Not Settled, at Amortized Cost:	
U.S. Agency Securities	$ 11,491
Total Investments (Trade Date Basis)	$ 3,961,059
Interest Bearing Bank Deposits	$ 548,405
Certificates of Deposit	132,250
Cash	183
Interest Receivable	7,684
Total Other Assets	$ 688,522
Total Assets	$ 4,649,581
Liabilities	
Accrued Expenses	$ 142
Obligations under Securities Lending Agreement	27,641
Investment Trades Pending Payable	11,607
Total Liabilities	$ 39,390
Net Assets	$ 4,610,191
Total Amortized Cost - Settlement Date Basis	$ 4,630,223

QUARTER AT A GLANCE

July 1, 2005 to September 30, 2005

(In Thousands)

Total investment purchases:		$ 42,551,600
Total investment sales:		$ 279,958
Total investment maturities:		$ 42,666,367
Total net income:		$ 38,907
Net of realized gains and losses:		$ 45
Net Portfolio yield (360-day basis):		
	July	3.2135%
	August	3.3998%
	September	3.5788%
Average weighted days to maturity:		25 days



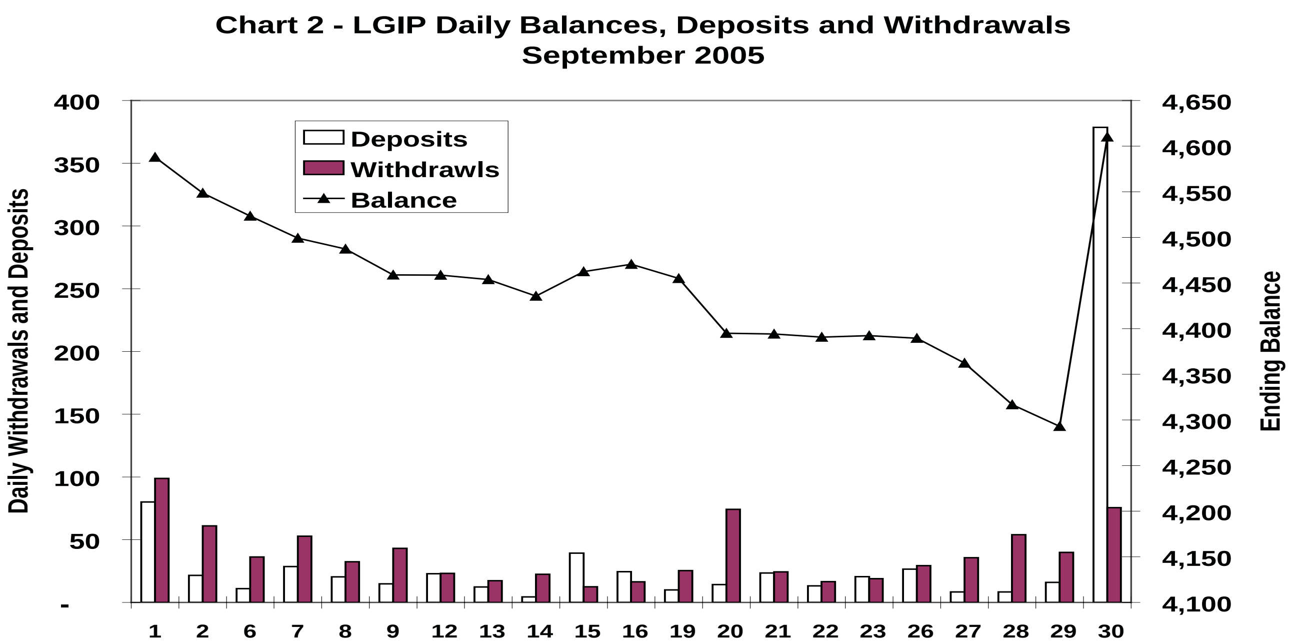


Chart 1 shows the monthly totals for deposits and withdrawals, as well as the end of month LGIP balance, for the last twelve months. Total deposits have averaged $996 million per month over the last year while withdrawals have averaged $989 million. The seasonality in cashflows brought about by the property tax cycle is certainly evident in the overall LGIP balances as well as the deposit and withdrawal patterns. Total activity has averaged about $95 million per business day. However, tax collections and distributions to or from the state certainly have a large impact on the level of daily activity, as can be seen from the graph of daily deposits and withdrawals during the month of September (Chart 2).

WASHINGTON STATE LOCAL GOVERNMENT INVESTMENT POOL
OFFICE OF THE STATE TREASURER
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OLYMPIA WA 98504-0200

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